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Supreme Court of the United States

OCTOBER TERM, 1949.

No. [redacted] 91

MAY, STERN AND COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI.

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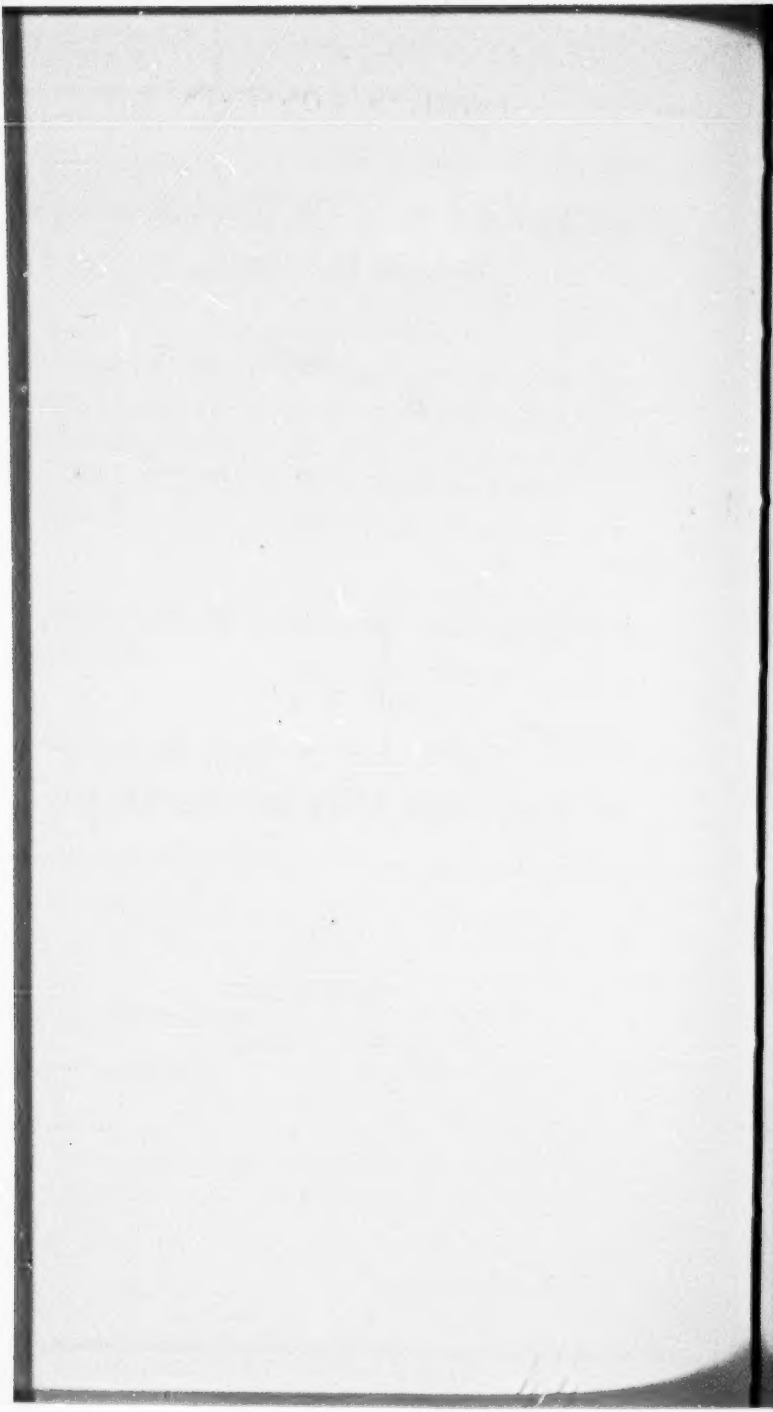

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Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI.

To the Honorable the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

Petitioner prays that a writ of certiorari be issued to the United States Court of Appeals for the Third Circuit to review a judgment of that court rendered in the above case on April 10, 1950 (R. 49), affirming a decision of The Tax Court of the United States that there was a deficiency in the petitioner's excess profits tax for its taxable year ended January 31, 1941 in the amount of $24,474.16 (R. 27a).

Petitioner submits that the Court of Appeals committed errors of law in reaching a result contrary to applicable statutory provisions, not in accord with applicable decisions of this Court, and in conflict with decisions of other Courts of Appeals in cases not significantly different from the present case (in which petitions by the Commissioner for writs of certiorari are now pending as Dockets No. 804 and 805).

Summary Statement of the Matter Involved.

The decision below held that a taxpayer's election under §736(a) I. R. C.* to compute its income from installment sales on the accrual basis "for the purposes of the tax imposed by this subchapter [the excess profits tax]" authorized such computation to be made in determining only one of the several factors entering into the tax base.

(a) Framework of the Excess Profits Tax Statute (Subchapter E of Chapter 2, I. R. C., 54 Stat. 975).

Section 710(a) I. R. C. imposes the excess profits tax on "adjusted excess profits net income, as defined in subsection (b)", which under §710(b) depends on several factors. Of these only two, "excess profits net income (as defined in section 711)" and "the excess profits credit allowed under section 712", are here material.

First Factor. Under §711 the "excess profits net income" is based on "normal-tax net income, as defined in section 13(a)(2) [of chapter 1, imposing the income tax]", which in turn depends on "net income" as defined in §21 and on "gross income computed under section 22."

Second Factor. Section 712 provides that the excess profits credit shall be an amount computed under §713 or §714. The latter section is applicable here and allows a credit based on invested capital, which under §718(a)(4) includes "the accumulated earnings and profits as of the beginning of [the] taxable year." The Code contains no comprehensive definition of "earnings and profits" but Reg. 103, §19.115-3 (now Reg. 111, §29.115-3) provides that "the amount of the earnings or profits in any case will be

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* Printed below at p. 17.

dependent upon the method of accounting properly employed in computing net income." This regulation was specifically made applicable to the excess profits tax by Reg. 109, §30.718-2. Section 115(l) I. R. C. also establishes rules correlating the effect on earnings and profits of gains from the sale of property with the method of computing net income and, as pointed out by Example (2) of Reg. 103, §19.115-12 (now Reg. 111, §29.115-12), the effect for excess profits tax purposes is not always the same as for income tax purposes.

In the case of an installment seller, both of these factors entering into the excess profits tax base will depend on income from installment sales, since such income is an ingredient of both gross income and accumulated earnings and profits.

(b) Position of the Present Facts in the Statutory Framework.

The deficiency in excess profits tax found by the decision below results solely from computing the two excess profits tax factors above referred to on inconsistent methods of accounting. There is no deficiency if the same method is used for both factors, whichever method is used. As the court below stated (R. 48):

> "We are keenly aware that the result we have reached requires inconsistent accounting in the taxpayer's 1940 return [its return for the taxable year ending January 31, 1941]. In the language of the Supreme Court in the *South Texas* case, this 'results in a distorted picture which makes a tax return fail truly to reflect net income'."

More specifically, in calculating the petitioner's "adjusted excess profits net income" under §710 I. R. C., the Commissioner and the courts below,

> FIRST, properly computed the petitioner's income from installment sales on the accrual basis, in deter-

mining the petitioner's gross income under §22 I. R. C. in order to arrive at the amount of the *first* factor in the calculation, but

SECOND, and inconsistently, computed such income on the installment basis, in determining the petitioner's "accumulated earnings and profits as of the beginning of [the] taxable year" under §718(a)(4) I. R. C. in order to arrive at the amount of the *second* factor in the calculation.

In particular, in these computations, over $500,000 of income from installment sales made in years prior to the taxable year here involved was treated (a) as *not* having been earned *until the taxable year* for the purposes of the excess profits credit, but (b) as having been earned *prior to the beginning of the taxable year* for gross income purposes.

The result of this inconsistent and contradictory system of accounting was correctly conceded (R. 48-49) by the court below to be a "distorted picture" resulting in hardship to the petitioner. The petitioner's combined income and excess profits taxes for the taxable year as determined by the decision below ($95,543.10) are more than the petitioner's net income for the year as so determined for income tax purposes ($94,875.44), and the excess profits tax alone ($74,474.16) exceeds the amount of the adjusted excess profits net income of an ordinary accrual basis taxpayer having the same sales, receipts, disbursements, etc. as the petitioner ($68,733.38).

Jurisdiction.

The jurisdiction of this Court is invoked under §1254(1) of the Judicial Code (28 U. S. C. §1254(1)) and §1141(a) of the Internal Revenue Code (26 U. S. C. §1141(a)).

Opinions of the Courts Below.

The opinions of the Tax Court (R. 8a, 19a) are reported in 5 T. C. M. 806 and 7 T. C. M. 309. The opinion of the Court of Appeals for the Third Circuit (R. 37-49) is not yet officially reported.

Questions Presented.

In determining a taxpayer's accumulated earnings and profits as of the beginning of the taxable year under §718(a)(4) I. R. C. for the purpose of computing its excess profits credit, is the taxpayer's income from installment sales to be computed on the accrual basis, or is it to be computed on the installment basis, where the taxpayer has properly elected under §736(a) I. R. C. "for the purposes of the tax imposed by this subchapter [i. e., the excess profits tax]" to compute its income from installment sales "on the basis of the taxable period for which such income is accrued, in lieu of the basis provided by section 44(a) [i. e., the installment basis]."

Statement of Facts.

The petitioner is a corporation organized under the laws of Pennsylvania, with its principal place of business in Pittsburgh, where it has been engaged for many years in the retail sale of home furnishings (R. 5a). Its books of account have been kept on the accrual basis (R. 14a).

The excess profits tax returns originally filed by the petitioner for the taxable years ended January 31, 1941 and January 31, 1942 (the petitioner's first and second excess profits tax taxable years) included in gross income the petitioner's income from installment sales computed on the

installment basis provided by §44(a) I. R. C. This was required because the petitioner had, many years prior to the enactment of the excess profits tax, elected for income tax purposes to report its income from installment sales on that basis (R. 5a, 14a).

In accordance with §44(a), the returns so filed included in income from installment sales for the taxable years ended January 31, 1941 and January 31, 1942, some income from installment sales made in years prior to the excess profits tax, and excluded some income from installment sales made during the years for which those returns were filed (the amounts included and excluded depending on the percentage of the sales price paid during those years). In particular, included in income from installment sales for the taxable year here in question (the taxable year ended January 31, 1941) was over $500,000 of income from installment sales made in prior years (Tr. Docs. 13, 14).

No excess profits tax was due on the return originally filed for the taxable year here in question (Tr. Doc. 14).

Subsequently, in the Revenue Act of 1942, Congress enacted a relief provision to allow installment basis taxpayers meeting certain specified requirements to elect, for excess profits tax purposes, to compute income from installment sales on the accrual basis* (§222(d), adding §736(a) to the Internal Revenue Code). The operation of §736(a) was briefly summarized in S. Rep. No. 1631, 77th Cong., 2nd Sess. (1942-2 C. B. 504, 540), in commenting on the committee's revision of the installment relief provision which the House had passed:

> "For example, a taxpayer whose outstanding installment accounts receivable averaged $50,000 at the

* The nature of, and reasons for, the relief requested are stated in Hearings Before Committee on Ways and Means on Revenue Revision of 1942, 77th Cong., 2nd Sess., 1676-80, 1716-27 (1942).

close of the years 1938, 1939, 1940, and 1941, and whose outstanding installment accounts amounted to $25,000 at the close of 1942, would be eligible to compute its income from installment sales on the accrual basis, for the purposes of excess-profits tax, both for 1942 and *for any preceding taxable years.*" (Italics added.)

The petitioner, having met the requirements specified in §736(a), elected in its return for its taxable year ended January 31, 1943 (its third excess profits tax taxable year) to compute its income from installment sales on the accrual basis for excess profits tax purposes (R. 5a). In compliance with the requirements of that section and Reg. 109, §30.736 (a)-2(d), it filed amended excess profits tax returns for its taxable years ended January 31, 1941 and January 31, 1942, computing its income from installment sales on the accrual basis (see, for example, the original and amended returns for the taxable year here involved, in the record as Docs. 13, 14, 15 and 16).

In so doing, the petitioner adjusted its income from installment sales for the year ended January 31, 1941 in conformity with its election, so as to exclude approximately $500,000 on account of installment sales made prior to the taxable year and to include approximately $1,000,000 on account of installment sales made during the taxable year which was not includible in the return originally filed on the installment basis.* In determining the petitioner's accumulated earnings and profits as of the beginning of the taxable year in the amended return, the petitioner's income from installment sales was computed consistently, i.e., on the accrual basis. Thus, the $500,000 which had been excluded from gross income as having been earned in prior years was

* The exact amounts are shown by the returns in the record to be $556,506.40 and $1,034,403.51, respectively (Docs. 13 and 15).

considered part of the petitioner's accumulated earnings and profits as of the beginning of the taxable year.

The net effect of the adjustments which were made was to increase the petitioner's adjusted excess profits net income for the taxable year, so that the amended return showed an excess profits tax due of $17,070.38 (Tr. Doc. 16).

The court below held that §736(a) I. R. C. did not authorize items of income which, in determining gross income, were properly treated thereunder as having accrued prior to the taxable year to be treated in the same way in determining the excess profits credit, and that, in the absence of such authorization, §115(l) I. R. C. required the excess profits credit to be computed on the basis of accounting used for income tax purposes, despite the resulting distortion in the petitioner's excess profits tax return.

Reasons for Granting the Writ.

1. The decision of the court below is contrary to the provisions of §736(a) and conflicts with the interpretation placed upon that section by every other Court of Appeals which has considered it.

Notwithstanding the statutory direction that the election under §736(a) is "for the purposes of the tax imposed by this subchapter [the excess profits tax]," the court below held that the election did not apply to the determination of the excess profits credit, one of the factors entering into the calculation of the tax base. As stated in the Commissioner's petitions for certiorari in *Comm'r* v. *Busch's Kredit Jewelry Co., Inc.*, No. 804, and *Comm'r* v. *John Breuner Co.*, No. 805, both filed May 5, 1950, the Second Circuit, Fourth Circuit and Ninth Circuit have held to the contrary. *Busch's Kredit Jewelry Co., Inc.* v. *Comm'r*, 179 F. 2d 298 (2d Cir. 1950); *Kimbrell's Home Furnishings,*

Inc. v. *Comm'r*, 159 F. 2d 608 (4th Cir. 1947); and *John Breuner Co.* v. *Comm'r*, 179 F. 2d 685 (9th Cir. 1950)*.

The Commissioner has also applied for certiorari in *Comm'r* v. *Basalt Rock Co., Inc.*, No. 803, filed May 5, 1950, involving a decision of the Ninth Circuit (180 F. 2d 281) holding invalid a regulation which required an election as to long-term contracts under §736(b), made "for the purposes of this subchapter [the subchapter imposing the excess profits tax]," to be effective for the purpose of computing "corporation surtax net income, computed under section 15" in determining the limit under §710(a)(1)(B) on the taxpayer's combined income tax and excess profits tax. The Tax Court had held the election effective for all purposes of the excess profits tax, saying (10 T. C. 600, 606):

> "The only reasonable interpretation of the statute, in our view, requires the use of the basis elected, for *every* purpose of subchapter E of chapter 2, * * * To say that the regulation is unreasonable or inconsistent with statute in requiring application of the elected method to both subsections seems to us impossible. On the contrary, it seems affirmatively provided by the text, which applies the elected method to the entire subchapter dealing with the excess profits tax. We think any other interpretation than that expressed in the regulation would be not

* The Ninth Circuit read the second and third sentences of §736(a) as making an exception in the case of income from installment sales made prior to the excess profits tax. The court below correctly disagreed with this exception for reasons stated in its opinion (R. 43) and in *Comm'r* v. *Mackin Corp.*, 164 F. 2d 527, 529-530 (1st Cir. 1947) and held that nothing in the statute *prevented* the election from applying to such income. The court below read the opinion of the Fifth Circuit in *White Bros. Co.* v. *Comm'r*, 180 F. 2d 451 (1950), as placing the same construction on the second and third sentences of §736(a) and disagreed with that opinion for the same reasons. However, that case did not involve the determination of accumulated earnings and profits as of the beginning of the taxable year under §718(a)(4) and the election under §736(a) in fact did not apply to any of the installment income there considered.

only inconsistent with the statute, but in the face of its language and purpose." (Italics in original.)

The Tax Court gave the same meaning to the words "for the purposes of the tax imposed by this subchapter" appearing in §736(a) when a similar issue arose in *Sokol Bros. Furniture Co.*, C. C. H. Dec. 16,878(M) (March 10, 1949, now on appeal to the Fifth Circuit),* but inconsistently, in the same decision, refused to apply that reasoning to the determination of the taxpayer's accumulated earnings and profits under §718(a)(4).

After considering the language of §736(a) defining the election, the court below said (R. 45-46):

> "But even if the quoted language might, by itself, be construed to cover income from past installment sales used in computing earnings and profits and to authorize the computation of income for such purposes on the accrual basis, to this extent superseding

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* It is to be noted that Reg. 109, §30.736(a)-3, making an election under §736(a) applicable to the computation of "corporation surtax net income, computed under section 15" for the purposes of §710(a)(1)(B), is inconsistent with Reg. 109, §30.736(a)-2, relied on by the Commissioner herein, providing:

> "The election made pursuant to section 736(a) and this section to compute income on the straight accrual basis in lieu of the basis provided in section 44(a) shall apply *only with respect to excess profits net income* for purposes of the excess profits tax imposed by Subchapter E of Chapter 2." (Italics added.)

The inconsistency results from the fact that "excess profits net income" does not depend on "corporation surtax net income." The quoted provision is also inconsistent with the provision next preceding it in the same section (particularly as construed by *Hadley Furniture Co.* v. *U. S.*, 87 F. Supp. 590 (D. Mass. 1949)) under which the §736(a) election affects accumulated earnings and profits to the extent "such election is reflected in the amount of income tax or excess profits tax payable for taxable years beginning after December 31, 1939."

This attempt to limit a §736(a) election was first promulgated *after* the due date of the first returns in which the election could be made (T. D. 5257, filed April 8, 1943, 8 Fed. Reg. 4692-4704).

and negating the requirements of §115(1), the taxpayer does not solve its problem. * * * The preceding years are dealt with in the following sentence of §736(a) providing that '*income from installment sales for each taxable year before the first year* with respect to which the election is made but beginning after December 31, 1939, *shall be adjusted* for the purposes of this subchapter to conform to such election'. (Italics added.) This is more restrictive language than that of the preceding sentence. A time limit appears which is absent in the preceding sentence. It is only income from installment sales for 1940 and 1941 which is to be adjusted. In our view, income from installment sales for 1940 cannot reasonably be construed to include income from installment sales made before 1940 and reflected in the 1940 return solely as accrued earnings and profits.

"Thus, we can not find in §736(a) any direction either authorizing or prohibiting the use of uncollected profits of pre-1940 installment sales in the earnings and profits component of invested capital as determined at the beginning of 1940."

The foregoing suggestion that an election under §736(a) might not affect a year for which an adjustment was required (i.e., a year for which an excess profits tax return on the installment basis had been filed prior to the election) to the same extent as in the case of years not requiring adjustment (i.e., years for which, because of the election, the excess profits tax returns were originally filed on the accrual basis) is based on the following errors:

(i) The court overlooked the fact that the sentence dealing with the retroactive application of the election refers back to the preceding sentence in requiring the retroactive adjustment to be made "to conform to such election," *i.e.*, the election described in the preceding sentence.

(ii) The court read "the income from installment sales *for* each taxable year," appearing in the sentence requiring the retroactive adjustment, as being the equivalent of "the income from installment sales *made in* each taxable year," notwithstanding the fact that the petitioner's "income from installment sales *for* 1940," which was to be adjusted under the statute (*i. e.,* the income reported on the original return) actually contained, and *reflected in gross income,* over $500,000 of income from installment sales made before 1940 (Tr. Docs. 13, 14). Indeed, Congress' basic reason for permitting the adjustment was the fact that "the income from installment sales for each taxable year" *did,* under the installment method of accounting, include income from sales of prior years.

(iii) The court failed to realize that its construction of the statute resulted, not merely in inconsistency of methods of accounting, but also in *contradictory treatments of a single item in a single return,* in that its decision required the amended return for the taxable year here involved to treat approximately $500,000 of income from installment sales made in prior years as having been earned *during the taxable year* in determining the excess profits credit, but as having been earned *prior to the taxable year* in determining gross income.

For these reasons the court below erred in holding that §736(a) did not affirmatively authorize income from installment sales made prior to 1940 to be adjusted to conform to the election.

2. The decision below improperly requires inconsistent tax accounting in conflict with the decision of this Court in *Comm'r* v. *South Texas Lumber Co.,* 333 U. S. 496 (1948), and with the decision of the Court of Appeals for the Second Circuit in *Busch's Kredit Jewelry Co., Inc.* v. *Comm'r,*

supra, (179 F. 2d 298), which applied the holding of the *South Texas* case to the case of a taxpayer reporting under §736(a) I. R. C.

The reasons stated by this Court for granting certiorari on the Government's application in the *South Texas* case apply with greater force in the present case, viz. (333 U. S. 499-500):

> "The Government's petition for certiorari alleged that the result reached by the Circuit Court of Appeals was counter to the Commissioner's regulations and to long-standing tax practices recognized by statutes and judicial opinions, under which practices a taxpayer normally cannot report taxable income on one accounting basis and adjustments of that income on another. The questions thereby raised are of importance in tax administration and we granted certiorari to consider them."

On considering the issues there presented, this Court sustained the "long-standing tax practices" referred to, holding (contrary to the taxpayer's contentions) that nothing in §115(l) I. R. C. required the use of inconsistent, or "hybrid," methods of accounting, and that the taxpayer was obliged to compute its excess profits credit under the same method of accounting it used in computing gross income for excess profits tax purposes.*

Application of the principles of the *South Texas* case to an election under §736(a) was required by the Second

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* This Court held specifically that §115(l) should be applied, not only with reference to the "recognition" provisions contained in §112 I. R. C., but also with reference to the method of accounting used in computing income, and stated (333 U. S. at 504):

> "* * * neither §115(l) nor any other purports to alter the Commissioner's power to promulgate reasonable regulations which require taxpayers who adopt the installment basis of accounting to use an accounting method that reflects true income [e.g., Reg. 111, §29.115-3]. The hybrid method here urged would not accomplish that result."

Circuit in *Busch's Kredit Jewelry Co., Inc.* v. *Comm'r, supra* (179 F. 2d 298), where the court said (p. 299):

> "The Tax Court differed with the decision rendered by the Court of Appeals for the Fourth Circuit in *Kimbrell's Home Furnishings, Inc.* v. *Commissioner,* 159 F. 2d 608. In that case, as in the case at bar, the taxpayer had elected to report income for excess profits tax on an accrual basis. The Fourth Circuit allowed the equity invested capital also to be reported on the accrual basis for the purpose of computing the 8% credit. While the Commissioner did not seek to review the decision of the Fourth Circuit by petitioning for a writ of certiorari, he now argues that the opinion by Justice Black in *Commissioner* v. *South Texas Lumber Co.,* 333 U. S. 496, whereby a decision of the Fifth Circuit reported at 162 F. 2d 866, was reversed, shows that the decision of the Fourth Circuit in *Kimbrell's Furnishings, Inc.* v. *Commissioner, supra,* was erroneous. *We cannot regard the contention of the Commissioner as sound.* The case before the Supreme Court was one where net earnings had been reported on an installment basis for the excess profits tax as well as for the regular income tax, whereas the 8% credit was claimed on equity invested capital computed on an accrual basis. In rejecting such a 'hybrid method' of accounting, Mr. Justice Black said: '[The applicable regulation] is in harmony with the long-established congressional policy that a taxpayer generally cannot compute income taxes by reporting annual income on a cash basis and deductions on an accrual basis. Such a practice has been uniformly held inadmissible because it results in a distorted picture which makes a tax return fail truly to reflect net income. This has been the construction given income, estate, and previous excess profits tax laws by administrative officials, the Board of Tax Appeals, and the courts.' 333 U. S. at 501, 504.
>
> *"In our opinion the method of accounting required by the Commissioner in the case at bar would be just*

> *such a 'hybrid method' of accounting as was held improper by the Supreme Court.* It seems to us quite unnatural to report equity invested capital for the excess profits tax credit on a cash basis. Yet this is exactly what the Commissioner holds to be necessary." (Italics added.)

The court below, however, because of the circumstance that in the *South Texas* case the taxpayer reported for income tax purposes on the same basis as for excess profits tax purposes, was able to mistake this Court's discussion of the phrase "recognized in computing net income" in §115(l) as referring to net income for income tax purposes, rather than net income for excess profits tax purposes, and construed §115(l) so as to negative all this Court had said on the principle of consistency. The Court's opinion shows that, apart from this mistake, it would have sustained the petitioner (R. 43, 46):

> "In these circumstances the reasoning of the Supreme Court in the earlier part of the *South Texas* opinion and the language of the Treasury Regulation there considered [Reg. 111, §29.115-3*] are applicable. They clearly state the propriety, absent any statutory requirement to the contrary, of accounting in the amended 1940 return for accumulated earnings and profits as well as annual income on the accrual basis. It is only in this way that this adjustment to taxable income can be placed on the same basis as the computation of income, and the internal consistency of the return, so strongly emphasized in the *South Texas* case, can be achieved. *Indeed, so forceful is the impact of the language and reasoning of the* South Texas *opinion on this point that it seems necessary to approve taxpayer's use of the accrual method in calculating earnings and profits from past*

* The same provisions are contained in Reg. 103, §19.115-3, which, under Reg. 109, §30.718-2, is applicable here.

installment sales unless some statutory prohibition necessitates disapproval.

* * * * * *

"Thus, we can not find in §736(a) any direction either authorizing or prohibiting the use of uncollected profits of pre-1940 installment sales in the earnings and profits component of invested capital as determined at the beginning of 1940.

"We are compelled, therefore, to adhere to our conclusion that §115(l) is applicable. Consequently, just as before the enactment of §736(a), we are controlled by the holding of the *South Texas* case that recognition *for income tax purposes* is a condition precedent to the inclusion of receipts from installment sales in accumulated earnings and profits [for excess profits tax purposes]." (Italics added.)

It is submitted that this Court's extended discussion and condemnation of hybrid accounting methods (under which income is reported on one accounting basis and "adjustments of *that income*" on another) cannot be so disregarded, and that the *South Texas* opinion necessarily requires adjustments of income for excess profits tax purposes (including adjustments dependent on §115(l)) to be computed on the accounting basis used in determining gross income for purposes of the *same* tax, and not on the basis used for some other tax.

Conclusion.

The petition for a writ of certiorari should be granted.

Respectfully submitted,

LOUIS CAPLAN,
CHARLES C. MACLEAN, JR.,
RAY I. HARDIN,
Counsel for Petitioner.

May, 1950.

Appendix.

SEC. 736. I. R. C. RELIEF FOR INSTALLMENT BASIS TAXPAYERS AND TAXPAYERS WITH INCOME FROM LONG-TERM CONTRACTS.

(a) ELECTION TO ACCRUE INCOME.—In the case of any taxpayer computing income from installment sales under the method provided by section 44(a), if such taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that the average volume of credit extended to purchasers on the installment plan in the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the volume of such credit extended to such purchasers in the taxable year, or the average outstanding installment accounts receivable at the end of each of the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the amount of such accounts receivable at the end of the taxable year, or if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxapayer was in existence, in either case including only such years for which the income was computed under the method provided in section 44(a), it may elect, in its return for the taxable year, for the purposes of the tax imposed by this subchapter, to compute in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, its income from installment sales on the basis of the taxable period for which such income is accrued, in lieu of the basis provided by section 44(a). Except as hereinafter provided, such election shall be irrevocable when once made and shall apply also to all subsequent taxable years, and the income from installment sales for each taxable year before the first year with respect to which the election is made but beginning after December 31, 1939, shall be adjusted for the purposes of this subchapter to conform to such election. In making such adjust-

ments, no amount shall be included in computing excess profits net income for any excess profits tax taxable year on account of installment sales made in taxable years beginning before January 1, 1940. If the taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that in a taxable year subsequent to the year with respect to which an election has been made under the preceding provisions of this subsection it would not be eligible to elect such accrual method, the taxpayer may in accordance with such regulations elect in its return for such year to abandon such accrual method. Such election shall be irrevocable when once made and shall preclude any further elections under this subsection. For the taxable year for which the latter election is made and subsequent taxable years, income shall be computed in accordance with section 44(c).

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In the Supreme Court of the United States

OCTOBER TERM, 1950

No. 91

MAY, STERN AND COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 8a-13a) and its supplemental memorandum findings of fact and opinion (R. 19a-26a) are not reported. The opinion of the Court of Appeals for the Third Circuit (R. 37-49) is reported at 181 F. 2d 407.

JURISDICTION

The judgment of the Court of Appeals for the Third Circuit was entered on April 10, 1950. (R. 49-50.) The petition for a writ of certiorari was filed on May 26, 1950. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Whether in computing its excess profits tax credit, taxpayer, which filed its income tax returns on the installment basis under Section 44(a) of the Internal Revenue Code, and which elected under Section 736(a) to compute its excess profits net income on the accrual basis, may include its uncollected installment profits as of the beginning of the taxable year in its "accumulated earnings and profits" within the meaning of Section 718(a)(4) of the Internal Revenue Code for the purpose of computing the excess profits tax credit on the invested capital basis, notwithstanding that the uncollected profits were from pre-1940 sales and hence had been subjected neither to income nor excess profits taxes.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the statute and relevant Regulations are set forth in the Appendix, *infra*, pp. 10-17.

STATEMENT

The facts relevant to the issue raised by the petition for certiorari were found in the Tax Court's first opinion (R. 9a-11a) and were restated and additional facts found in its supplemental memorandum findings of fact. (R. 20a-22a.) They may be summarized as follows:

The taxpayer has its principal place of business in Pittsburgh. It is engaged in the business of buying and selling home furnishings to the retail trade, and sells merchandise under install-

ment sales contracts. It keeps its books of account and reports its income on the basis of a fiscal year ending January 31, and, in general, under the accrual method of accounting. It computes its income from installment sales contracts, however, on the installment basis for federal income tax purposes under Section 44 (a) of the Internal Revenue Code. (R. 20a-21a.)

Taxpayer's first taxable year under the Excess Profits Tax Act of 1940, began February 1, 1940, and ended January 31, 1941. In 1943, it elected under Section 736 (a) of the Code to compute income from its installment sales on the accrual basis for the purpose of the excess profits tax. Accordingly, it filed an amended corporation excess profits tax return for the fiscal year ended January 31, 1941, in which it reported, in its excess profits net income, income from that fiscal year's installment sales in the net amount of $363,896.09, as determined on the accrual basis. An amended corporation income tax return for the same year reported net income of $83,331.91. In that return, income from installment sales was reported on the installment basis permitted under Section 44 (a) of the Code. (R. 21a.)

In its amended excess profits tax return for the year ended January 31, 1941, taxpayer reported accumulated earnings and profits of $3,919,768.94.[1]

---

[1] Taxpayer computed its excess profits credit on the invested capital basis; under Section 718 of the Code one element of invested capital is "accumulated earnings and profits."

In this amount was an item of $1,297,745.79,[2] which represented unrealized earnings and profits on installment sales as of the beginning of that taxable year (February 1, 1940). These unrealized profits constituted that portion of taxpayer's accounts receivable representing uncollected gross profits on installment sales made prior to February 1, 1940. (R. 21a-22a.) They had not been reported as taxable income for either excess profits tax or income tax purposes (R. 21a-22a, 45).

The Commissioner excluded from taxpayer's equity invested capital as of February 1, 1940, the above amount of $1,297,745.79. This determination resulted in a reduction of the eight percent excess profits tax credit to $207,097.87, and led to a deficiency in excess profits tax (after other adjustments) in the amount of $89,774.93. (R. 22a.)

The Tax Court approved the Commissioner's determination (R. 22a-27a) and the Court of Appeals affirmed (R. 49-50).

ARGUMENT

1. The narrow question presented by this case lacks importance in itself, and the denial on May 29, 1950, of the Government's broader petitions for certiorari in *Commissioner* v. *Busch's Kredit Jewelry Co.*, 179 F. 2d 298 (C. A. 2), (No. 804, October Term, 1949), and *Commissioner* v. *John Breu-*

[2] The Tax Court opinion (R. 21a) sometimes refers to this item as being in the amount of $1,294,745.79 and (R. 22a) sometimes as being $1,297,745.79. The stipulated amount (R. 7a) must be taken as correct.

ner Co., 179 F. 2d 685 (C. A. 9), (No. 805, October Term, 1949), suggests that the present petition should likewise be denied. Those cases dealt with the related but different, and more important, issue of whether an installment-basis taxpayer under Section 44(a) of the Internal Revenue Code (*infra*, p. 10)—which had elected under Code Section 736(a) (*infra*, pp. 13-15) to report excess profits income on the accrual basis—could, as a result of the Section 736(a) election, include in earnings and profits under Section 718(a)(4) (*infra*, pp. 12-13) uncollected installment profits which had not been recognized for income tax purposes but because the sales had been made in excess profits tax years (*i. e.*, post-1939) had been recognized for excess profits tax purposes. The issue of those cases involved all of the excess profits tax years, and not merely pre-1940 earnings and profits, as here; a large number of pending cases were affected by the rulings sought to be reviewed. In contrast, the present case concerns only the narrower issue of the right of a taxpayer, which has made the Section 736(a) election, to include in earnings and profits uncollected installment profits resulting from sales made in pre-excess profits tax years (*i. e.*, pre-1940), and hence not realized or recognized for either income or excess profits tax purposes. This issue usually would affect only the earliest of the excess profits tax years, and it is doubtful if any

substantial number of other cases presenting the issue will arise.

2. Moreover, the decision below is in any event correct, reaches a result specifically directed by the Treasury Regulations, and presents no conflict. Both courts below held that an installment-basis taxpayer, electing under Section 736(a), may not include in earnings and profits uncollected installment profits attributable to pre-1940 sales, and accordingly not realized or recognized, at the time of the return, for either income or excess profits tax purposes. This is exactly the conclusion reached by two other Courts of Appeals (*John Breuner Co.* v. *Commissioner,* 179 F. 2d 685 (C. A. 9), certiorari denied on the Commissioner's petition on the other phases of the case, May 29, 1950 (No. 805, October Term, 1949; *White Bros. Co.* v. *Commissioner,* 180 F. 2d 451 (C. A. 5)).[3] It is also the result expressly required by the Regulations (Section 30.736(a)-2, Treasury Regulations 109 (Appendix, *infra,* p. 17)), and is in accord with the decision of this Court in *Commissioner* v. *South Texas Co.,* 333 U. S. 496. See also *Commissioner* v. *Wheeler,* 324 U. S. 542. There are no decisions to the contrary.

There is, thus, neither a conflict which would warrant the granting of the petition, nor a question of the correctness of the decision below under any

[3] The same result was also reached in *Hadley Furniture Co.* v. *United States,* 87 F. Supp. 590 (D. Mass.).

of the theories advanced by the lower courts as to the effect of Section 736(a):

(a) In the petition for certiorari in *Commissioner* v. *Busch's Kredit Jewelry Co., supra,* the Commissioner asserted (pp. 9, 11, 14) that the views expressed by the court below herein were inconsistent with those declared by the Second and other circuits reaching the result of that case.[4] That was because the court below seemed to interpret the impact of Section 736(a) on post-1939 accumulated earnings and profits, and to read its legislative materials, quite differently from the other courts. In addition, the Third Circuit's suggestion that Section 115 (l) (*infra,* p. 11), as construed by this Court (*Commissioner* v. *South Texas Co.,* 333 U. S. 496), requires that before an amount can be included in earnings and profits it must have been recognized for income tax purposes (R. 45-48), would, if logically applied to the *Busch's* issue, require a conclusion opposite to that reached by the Second, Fourth, and Ninth Circuits. But the converse is not true. Contrary to the implication of taxpayer's petition (pp. 8-12), the reasoning of the courts in *Kimbrell's, Busch's,* and *Breuner,* would not require a different conclusion on the issue of the present case. The same result is compelled whether one follows the reasoning of those cases, on the one

[4] *Kimbrell's Home Furnish., Inc.* v. *Commissioner,* 159 F. 2d 608 (C. A. 4); *John Breuner Co.* v. *Commissioner,* 179 F. 2d 685 (C. A. 9).

hand, or of the Third Circuit in the opinion below, on the other. Under the rationale of *Kimbrell's, Busch's* and *Breuner,* the critical question in determining what is to be included in earnings and profits is whether the amount sought to be included has been realized and recognized for excess profits tax purposes. Since Section 736(a) expressly provides that profits from sales in pre-excess profits tax years (*i.e.,* pre-1940) are not to be accrued for purposes of the excess profits tax (*infra,* p. 14), it is not possible to say that the uncollected profits in this case were either realized or recognized for excess profits tax purposes.[5] The consistency of the result below with the rationale of *Kimbrell's* and *Busch's* is illustrated by the fact that, in *John Breuner Co.* v. *Commissioner, supra,* the Court of Appeals for the Ninth Circuit, relying on *Busch's* and *Kimbrell's,* reached the result of those cases on the post-1939 earnings and profits, but on the issue of this case held with the Commissioner.[6]

(b) Nor is there any merit in the assertion (Pet. 12-16) that the decision below is contrary to the decision of this Court in *Commissioner* v. *South Texas Co.,* 333 U. S. 496. On the contrary, the court's decision turns (R. 46-48) on this Court's interpretation of Section 115(1) in *South Texas* (R. 45-48).

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[5] It is also, of course, true that they had not been realized or recognized for income tax purposes. R. 21a-22a, 45; *supra,* p. 4.

[6] The taxpayer did not seek certiorari in *Breuner.*

CONCLUSION

The decision below is correct. There is no conflict of decisions. The petition should be denied.

Respectfully submitted,

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JUNE 1950.

APPENDIX

Internal Revenue Code:

SEC. 44. INSTALLMENT BASIS.

(a) *Dealers in Personal Property.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

* * * * *

(26 U. S. C. 1946 ed., Sec. 44.)

SEC. 115 [as amended by Section 501 (a) of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, 1004, and as amended by Section 146 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798, 841]. DISTRIBUTIONS BY CORPORATIONS.

* * * * *

(l) *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(1) for the purpose of the computation of earnings and profits of the corporation, shall

be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. For the purposes of this subsection, a loss with respect to which a deduction is disallowed under section 118, or a corresponding provision of a prior income-tax law, shall not be deemed to be recognized. Where a corpora-

tion receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

(1) No such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made.

(2) No such increase shall be made if (under such law) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received.

* * * * *

(26 U. S. C. 1946 ed., Sec. 115.)

CHAPTER 2—ADDITIONAL INCOME TAXES

* * * * *

SUBCHAPTER E—EXCESS PROFITS TAX

* * * * *

SEC. 718 [As added by Section 201, Second Revenue Act of 1940, *supra*, and amended by Section 203 of the Revenue Act of 1941, 55 Stat. 687]. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and

shall be the sum of the following amounts, reduced as provided in subsection (b)—

* * * * *

(4) *Earnings and profits at beginning of year.*—The accumulated earnings and profits as of the beginning of such taxable year;

* * * * *

(26 U. S. C. 1946 ed., Sec. 718.)

SEC. 736 [As added by Section 222 (d) of the Revenue Act of 1942, *supra*]. RELIEF FOR INSTALLMENT BASIS TAXPAYERS AND TAXPAYERS WITH INCOME FROM LONG-TERM CONTRACTS.

(a) *Election to Accrue Income.*—In the case of any taxpayer computing income from installment sales under the method provided by section 44 (a), if such taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that the average volume of credit extended to purchasers on the installment plan in the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the volume of such credit extended to such purchasers in the taxable year, or the average outstanding installment accounts receivable at the end of each of the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the amount of such accounts receivable at the end of the taxable year, or if the taxpayer was not in existence for four

previous taxable years, the taxable years during which the taxpayer was in existence, in either case including only such years for which the income was computed under the method provided in section 44 (a), it may elect, in its return for the taxable year, for the purposes of the tax imposed by this subchapter, to compute, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, its income from installment sales on the basis of the taxable period for which such income is accrued, in lieu of the basis provided by section 44 (a). Except as hereinafter provided, such election shall be irrevocable when once made and shall apply also to all subsequent taxable years, and the income from installment sales for each taxable year before the first year with respect to which the election is made but beginning after December 31, 1939, shall be adjusted for the purposes of this subchapter to conform to such election. In making such adjustments, no amount shall be included in computing excess profits net income for any excess profits tax taxable year on account of installment sales made in taxable years beginning before January 1, 1940. If the taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that in a taxable year subsequent to the year with respect to which an election has been made under the preceding provisions of this subsection it would not be eligible to elect such accrual method, the tax-

payer may in accordance with such regulations elect in its return for such year to abandon such accrual method. Such election shall be irrevocable when once made and shall preclude any further elections under this subsection. For the taxable year for which the latter election is made and subsequent taxable years, income shall be computed in accordance with section 44 (c).

(b) *Election on Long-Term Contracts.*—

* * *

(c) *Adjustment on Account of Change.*—If an adjustment specified in subsection (a) or subsection (b), as the case may be, is, with respect to any taxable year, prevented, on the date of the election by the taxpayer under subsection (a) or subsection (b), as the case may be, or within two years from such date, by any provision or rule of law (other than this section and other than section 3761, relating to compromises), such adjustment shall nevertheless be made if in respect of the taxable year for which adjustment is sought a notice of deficiency is mailed or a claim for refund is filed, as the case may be, within two years after the date such election is made. * * *

(26 U.S.C. 1940 ed., Sec. 736.)

Treasury Regulations 109, promulgated under the Internal Revenue Code:

SEC. 30.736(a)-2 [as added by T.D. 5257, 1943 Cum. Bull. 856, 859]. *Election to Compute Excess Profits Income on Straight Ac-*

crual Basis.—If a taxpayer computing income from installment sales under the method provided by section 44 (a) establishes eligibility for relief under section 736 (a) and section 30.736(a)-1 with respect to a taxable year beginning after December 31, 1941, it may elect in its excess profits tax return for such year to compute income attributable to installment sales on the basis of the taxable period for which such income is accrued, in lieu of the basis provided by section 44 (a), pursuant to which income for any taxable year is determined to be that proportion of the installment payments actually received during the year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

* * * * *

If the taxpayer elects in a taxable year beginning after December 31, 1941, and under the provisions of section 736 (a) and this section to compute its income from installment sales on the straight accrual basis, such election shall be irrevocable when once made and shall apply also to all subsequent taxable years and the income from installment sales for each taxable year before the first year with respect to which the election is made, but beginning after December 31, 1939, shall be adjusted for the purposes of the excess profits tax computation to conform to such election. Since no change in the computation of income from the installment basis to the straight accrual basis can be made for any year beginning prior to

January 1, 1940, as a result of such election, no recomputation can be made for any year in the base period. If the taxpayer uses the excess profits credit based on income pursuant to section 713 or section 742, the average base period net income shall be the actual average base period net income with income from installment sales computed under the method pursuant to which such income was reported for the purposes of the income tax under Chapter 1 for the taxable years in such period. If the taxpayer uses the excess profits credit based on invested capital pursuant to section 714, the determination of accumulated earnings and profits shall be made without regard to any adjustment resulting from election made under section 736 (a) and this section, except as such election is reflected in the amount of income tax or excess profits tax payable for taxable years beginning after December 31, 1939. The election made pursuant to section 736 (a) and this section to compute income on the straight accrual basis in lieu of the basis provided in section 44 (a) shall apply only with respect to excess profits net income for purposes of the excess profits tax imposed by Subchapter E of Chapter 2. For purposes of the income tax under Chapter 1, or the surtax on personal holding companies or the declared value excess profits tax under Chapter 2, income shall be computed upon the basis provided in section 44 (a).

* * * * *

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